Conundrums and correlations – the remarkable state of global asset markets

By the Legal and General Asset Allocation Team
Julien Garran and Emma Brandwood

Remarkable assets

The current state of global macro and markets is truly extraordinary. We have seen the fastest three-year period of global growth for a generation, yet inflation, thus far, remains contained. Equity market volatility and credit spreads are close to all-time lows. Developed world equities, emerging market equities & debt and most commodities have seen a powerful three-year bull market. And 10-year treasury yields are lower than when the Fed started to hike rates back in June 2004. More than that, the performance of these once disparate asset classes has become highly correlated.

We ask how we got here, whether current conditions are sustainable, and which assets offer the most attractive returns at this point? We believe that the potential reward for a number of more speculative instruments no longer compensates investors for the risks involved. But several old world stalwarts, European equities for instance, still offer the potential for attractive returns.

Globalisation and goldilocks

Globalisation explains how we got here. Reform in emerging markets, outsourcing and the internet have boosted productivity, and shifted the global supply curve right. That, combined with easy money, spurred the powerful inflation-free growth of the past three years. That combination also provided the perfect environment for equities, commodities and credits to rise in tandem.

Hotting up – suggests risks to more speculative assets

But conditions are heating up. Resource utilisation is above average in the US and heading higher. The Fed has made it clear that it will be proactive in heading-off inflation. This suggests that risks will rise.

We believe that the risks to emerging market equities, to commodities and to credit derivatives is increasing. In particular we highlight those assets such as Indian, Polish and South African equities that have seen risk premiums almost vanish. Compressed term premiums in mid and long-dated government bonds, particularly in the UK, may widen further in this environment.

Developed world equities should fare better

But as many high risk assets appear priced for perfection, the prospect for more traditional assets, such as developed world equities, remains robust. Topline growth is robust, cash holdings are high and free cashflow yields are well in excess of risk free rates. This should continue equity friendly buybacks and takeovers as well as improving income growth at the banks. We are positive on developed world equities in 2006, particularly in Western Europe.

1. Conundrums and correlations – the remarkable state of global asset markets

1.1 Introduction

In August of last year Alan Greenspan made the following statement;

'This vast increase in the market value of asset claims is in part the indirect result of investors accepting lower compensation for risk. Such an increase in market value is too often viewed by market participants as structural and permanent. To some extent, those higher values may be reflecting the increased flexibility and resilience of our economy. But what they perceive as newly abundant liquidity can readily disappear. Any onset of increased investor caution elevates risk premiums and, as a consequence, lowers asset values and promotes the liquidation of the debt that supported higher asset prices. This is the reason that history has not dealt kindly with the aftermath of protracted periods of low risk premiums'.

Was Alan Greenspan jumping the gun, as he did in 1996 with his comments on 'irrational exuberance' in equity markets, four years before the peak? Or are there aspects of the recent performance of assets and economies that are unsustainable in the short run?

In this paper we examine the current state of asset markets and economies. We ask how we got here, when will these trends change, and how will they change.

Our central conclusion is that risks will rise over the next year. We advise reducing exposure to assets with compressed risk premiums such as emerging markets equity and debt. Government bonds offer poor value and are vulnerable to a rise in term premiums over the short term. However, they may offer an opportunity for tactical returns later in the year.

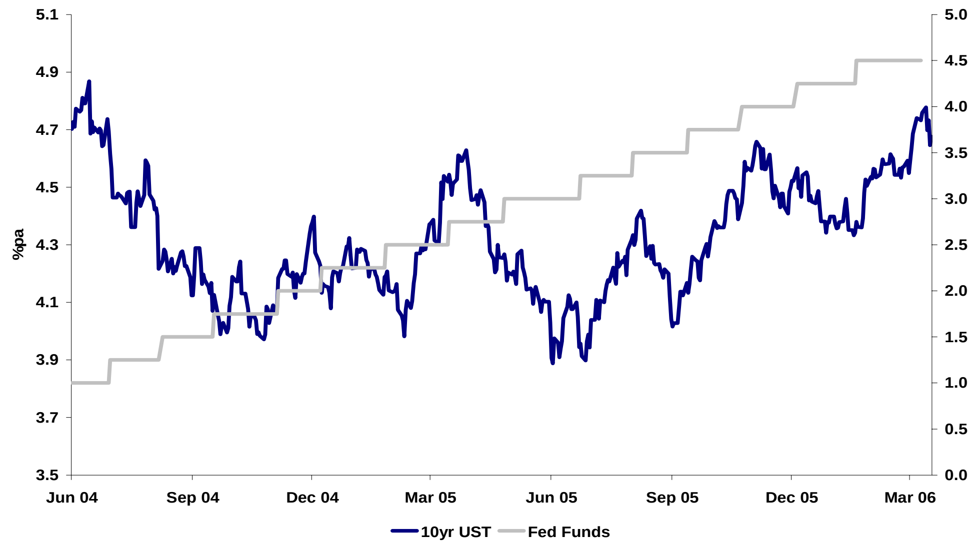
The prospect for equities in the developed world remains solid. Particularly in Europe, the UK, Japan and to a lesser extent in the US. In each case topline growth is robust, cash holdings are high and free cashflow yields are well in excess of risk free rates. This should continue equity friendly buybacks and takeovers as well as improving income growth at the banks. We are net positive developed world equities in 2006.

1.2 The state we're in

The current state of global macro and markets is truly extraordinary.

We have just seen the strongest three-year period of global growth for a generation. Yet inflation remains contained, and global interest rates languish below the averages of the past ten years. International imbalances, meanwhile, have reached unprecedented shares of GDP.

Chart 1: US Fed funds (RHS) vs the US 10-year treasury yield (LHS)



Source: Bloomberg

The US Federal reserve has raised rates by 375 basis points since June 2004, yet the yield on the US 10-yr bond has fallen for the first time ever in a tightening cycle (See chart 1).

Equity market volatility and credit spreads have hit all time lows. Emerging market bonds, emerging market equities and commodities have seen a powerful three-year bull-market.

But more than that, the performance of disparate asset classes have become correlated to an unprecedented degree. This correlation applies to developed world equities, to high yield debt, commodities, emerging market stocks and bonds and even to hedge funds with idiosyncratic trading styles. All have been moving up together (See chart 2).

Chart 2: The correlation between world equities and US high yield

Source: Bloomberg, LGIM Research

This poses some deep questions for the analyst, the fund manager, and the asset allocator. Can we rely on these trends to continue? If we cannot, then when and how will the trends change? And what will the implications be for our business; for the assets in the life fund and the society shareholders' funds, for the liability matching on those funds, and for the opportunities to use society shareholders' assets to fund future growth?

1.3 How we got here

Globalisation offers the single best explanation for these events.

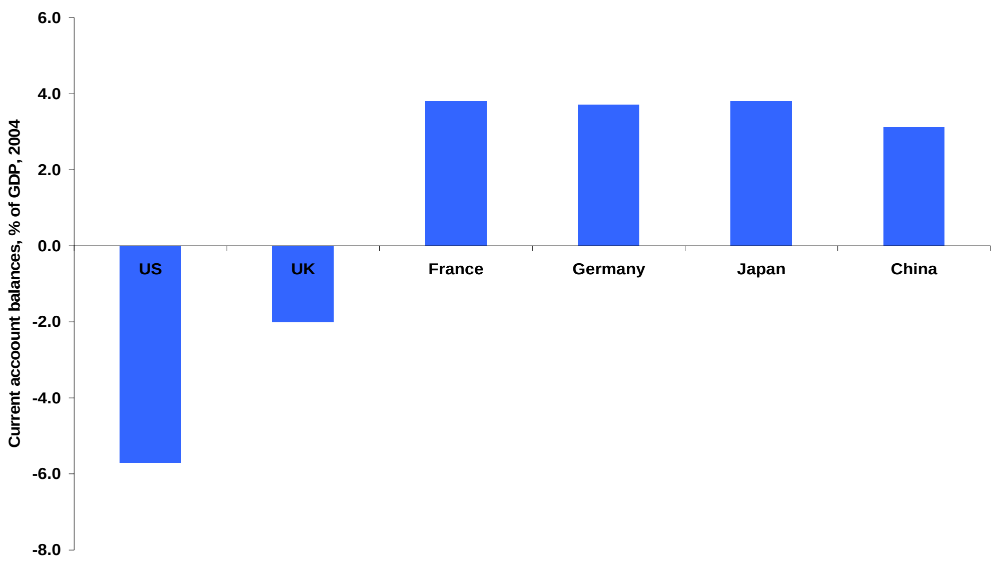
Alan Greenspan highlighted the importance of these trends in his speech 'On Globalisation' from May 2003. The fall of the Berlin Wall in 1989, combined with the liberalisation of markets from China to India, Russia and Brazil effectively added two billion new workers into the global capitalist economy. And given that the capital base in these areas was subpar, to say the least, it meant that the global capital to labour ratio collapsed. The critical point here is that the authorities in each of these regions realised the need for a modern and efficient capital base. So they sought to encourage foreign direct investment and joint ventures.

This combined with an increased desire from western countries to cut costs, in part through outsourcing. And with this increased desire came a rapidly improving technology – the internet – that allowed the outsourcing to multiply. Productivity boomed. Corporates claimed the lion's share of increased returns.

Greenspan's take on this was that global supply had expanded rapidly, demand was yet to catch up.

Now that helps to explains how the exceptional period of global growth that we have seen over the past three years failed to generate a commensurate rise in either inflation or interest rates. This expansion without inflation has generated almost the perfect environment for asset prices. But it does little to explain global imbalances (See chart 3).

Chart 3: Current account balances in the world's six biggest economies



Source: Bloomberg

1.4 Imbalances explained

Here the clearest understanding comes from Barry Eichengreen in a paper called ‘The blind men and the Elephant’. The thesis works as follows;

In a closed economy savings=investment. It’s an identity. But in an open economy with international capital flows, savings no longer have to equal investment for individual country, only for the world as a whole. So the basic equation looks like this

US		Rest of World
Investment - Savings	=	Savings - Investment

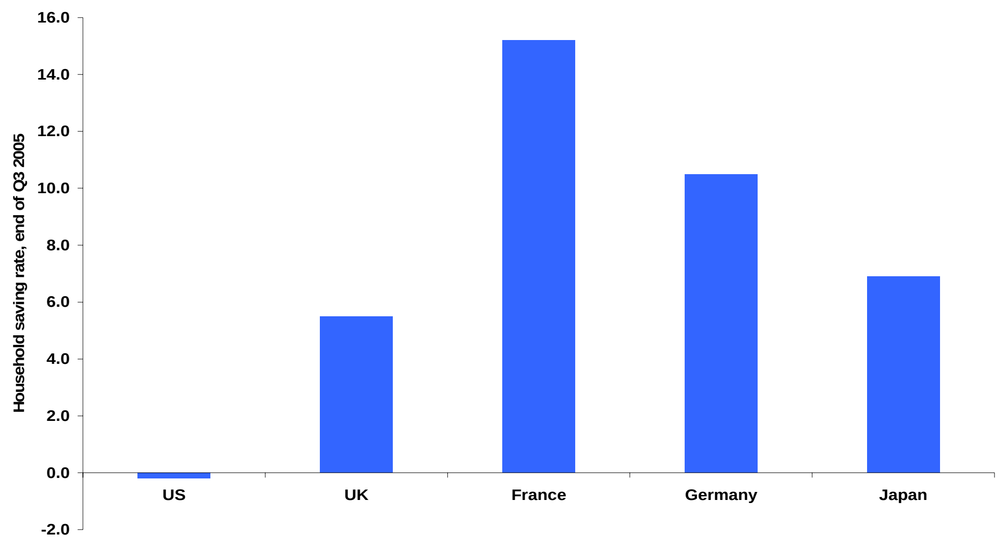
Now what’s neat about this is that it puts into context all the ‘explanations’ of global imbalances and it helps to measure the risks associated with each. Eichengreen’s comment about the squabbling factions; ‘everybody’s right’. Each may contribute to an understanding of the current environment.

1.4.1 US savings shortfall

Nicholas Roubini of Stern Business School and Steven Roach of Morgan Stanley both believe that the savings shortfall at the US consumer (and government) as the central cause of global imbalances. US consumers have borrowed against rising house and stock prices to live above their incomes like never before.

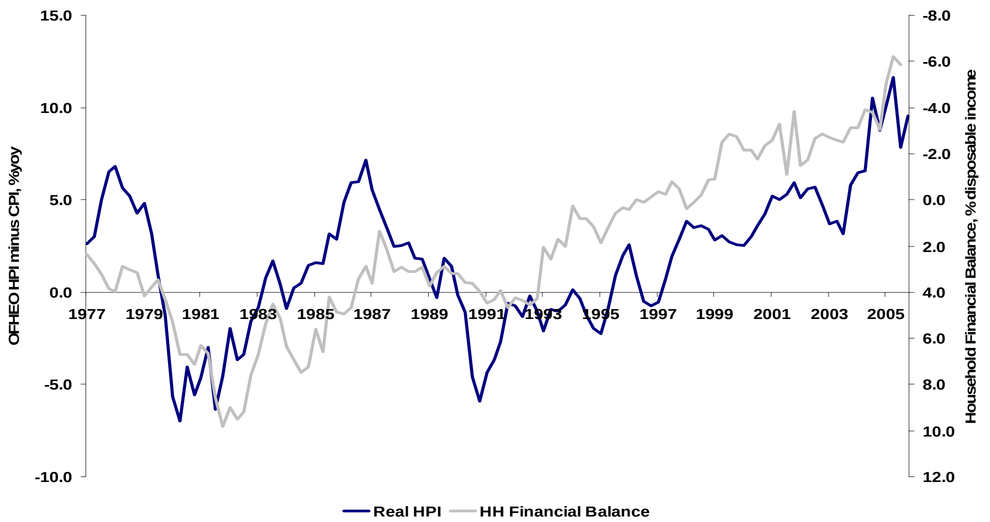
The implication is that the condition is unstable – that any slowdown in asset price appreciation, like the current slowdown in the US housing market right now, will cause the US consumer to retrench (see chart 5). This may trigger a significant global slowdown, and a possible collapse in the dollar, and a sharp rise in risk aversion.

Chart 4: Consumer savings rates in the G5



Source: Bloomberg

Chart 5: US real house price inflation vs the US household financial balance



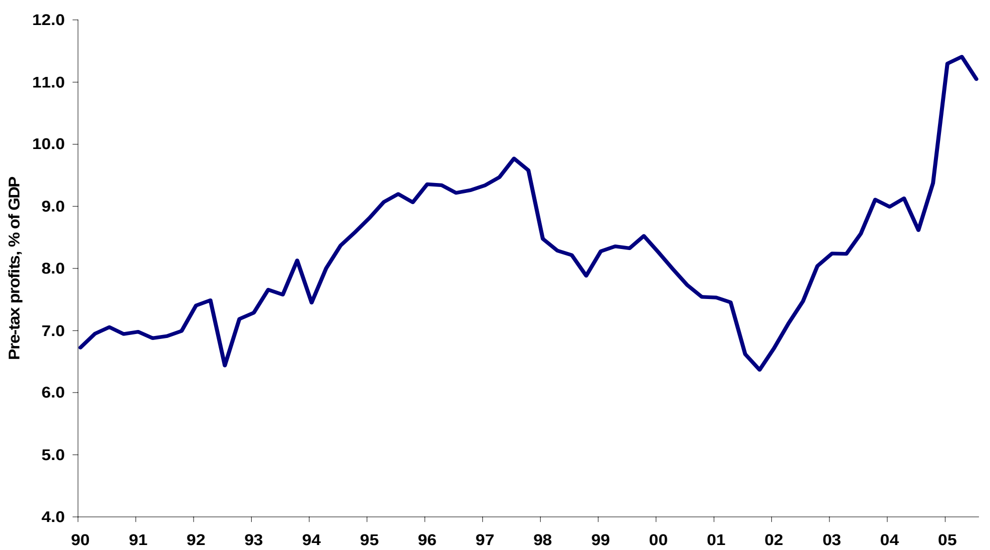
Source: Thomson Financial, LGIM Research

1.4.2 Too much corporate cash

Then there is the argument that it is simply corporates that have taken over as the big savers in the US, and globally. In reaction to the poor investment decisions of the late 1990s, corporates perceive that they are best servicing their shareholders through managing for cash, rather than for growth.

The implication here is that corporates may start to change their behaviour. They may raise employment and investment as capacity utilisation rises above trend. They may respond to investor demands for growth. They may, in short, make up for much if not all the loss of growth from an increase in consumer savings. This would generate a benign rebalancing. Interest rates would rise moderately and cheap developed world equities would outperform.

Chart 6: US all economy pre-tax profit as a share of GDP



Source: Bloomberg

1.4.3 Global savings glut

The next argument is the Bernanke savings glut thesis. Bernanke argued in a speech in March last year that it was emerging market governments that caused global imbalances. These governments sought above all else to protect themselves against a repeat of the emerging market crises of the 1990s – and there is a long list. So they built up foreign reserves in US dollars. This purchase of dollar debt then depressed yields in the US, causing asset prices to rise, and US consumers to borrow.

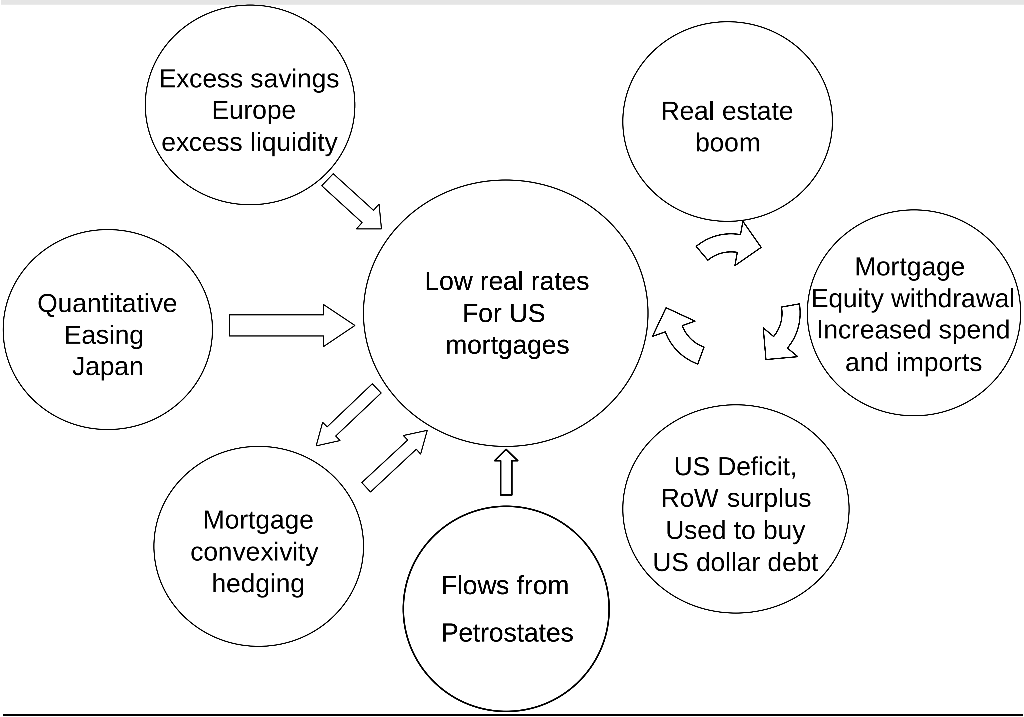
How is this resolved? When reserves offer sufficient protection against financial contagion. Or when domestic economies rebalance towards greater consumer spending. Gerber et al of Deutsche Bank argue that the rebalancing could take 20-years – over which time Chinese wages and productivity will have risen to Western levels, and the authorities will not have to buy US debt to hold the exchange rate down. There should be a gradual rise in the renminbi and a reinstatement of the US long bond term premium as this happens. Others argue that a reduction in global liquidity will reduce the Chinese's ability to buy US debt in 2006, and that a deliberate attempt to rebalance the economy towards consumption may reduce the desire to accumulate US debt.

The key conclusion here is that it is not the existence of imbalances, but the way that they are unwound that will determine the outlook for asset markets over the coming years.

1.5 Money-go-round

So how did this generate the boom in asset prices? Here's a chart we developed to show how money has moved around the global system, pulling assets up as it went. This probably best explains the period 2002-2004.

Chart 7: A 'Beyond Bretton Woods II' schematic



Source: LGIM Research

The central issue here is that US and global capacity utilisation is low, monetary policy is loose, and asset prices and activity is just starting to respond.

US House prices rise, US consumers take on more debt and buy more imports. This weakens the US current account deficit, and raises surpluses in China and the rest of the world. These funds are recycled into US treasuries and corporate debt, holding down rates and spurring further asset price gains in houses and equities.

Capital flows out of the US into higher risk assets like EMEA stocks and bonds, or commodities. The dollar falls. And excess liquidity in Japan and Europe adds to the bid on bonds.

So far so good. But now we move onto stage II.

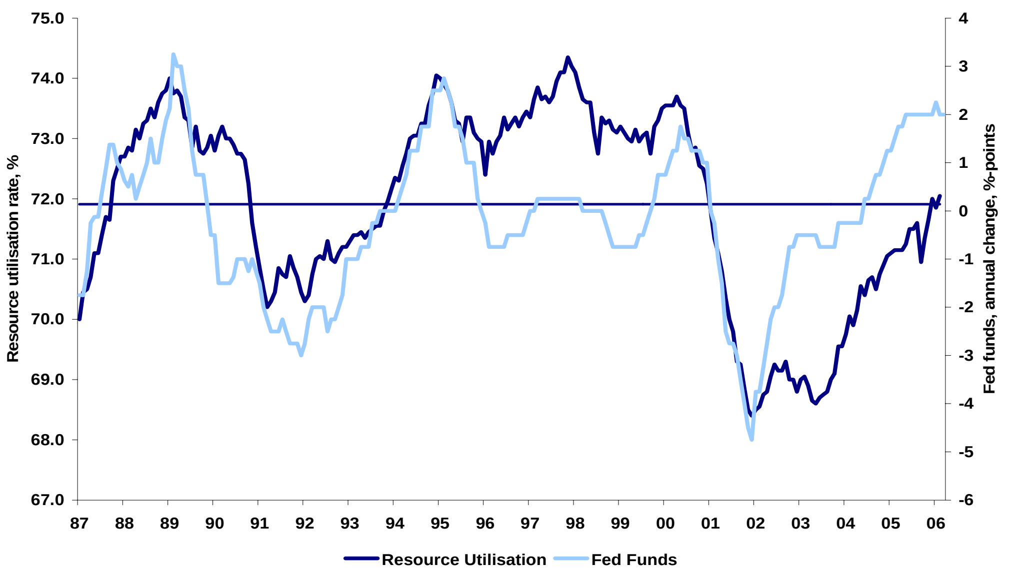
Capacity utililisation rates globally start to rise, and the Fed decides to remove accommodation. When US rates exceed those in other developed nations, this causes some liquidity to return to the US, forcing up the dollar.

But global capacity utilisation is low enough and inflation mild enough to prevent an aggressive global tightening campaign. Europe and Japan are still generating plenty of liquidity. Enough to spur continued rises in Emerging market bonds and equities, developed world equities and credits and commodities as well. This is a reasonable explanation of 2005.

1.6 Where we stand

Our central view is that global economic momentum is strong, resource utilisation is rising, core inflation remains muted, and that the Fed will pre-empt any sustained rise in inflationary pressure. This will likely require a move to 5.5% Fed Funds.

Chart 8: US Resource utilisation, with line showing neutral rate



Source: Bloomberg, LGIM Research

1.6.1 How sustainable is US growth?

The second issue is US growth. Will the corporate sector take over from consumer borrowing as the main driver of US growth?

There are four reasons to expect a solid if somewhat front outlook for US growth in 2006.

+ US corporate cashflows and balance sheets are very robust. Corporates continue to see solid topline growth. But after extremely slow hiring and capex in the recovery, there is now pent-up demand for both. Payrolls appears to have jumped from a 200,000 monthly average in 2005, and may exceed 250k from now.

+ There has been a broadening out of wage pressure. Previously just dockers and truckers, we are now seeing increasing white collar wage pressure in financial services, B-to-B services, software etc.

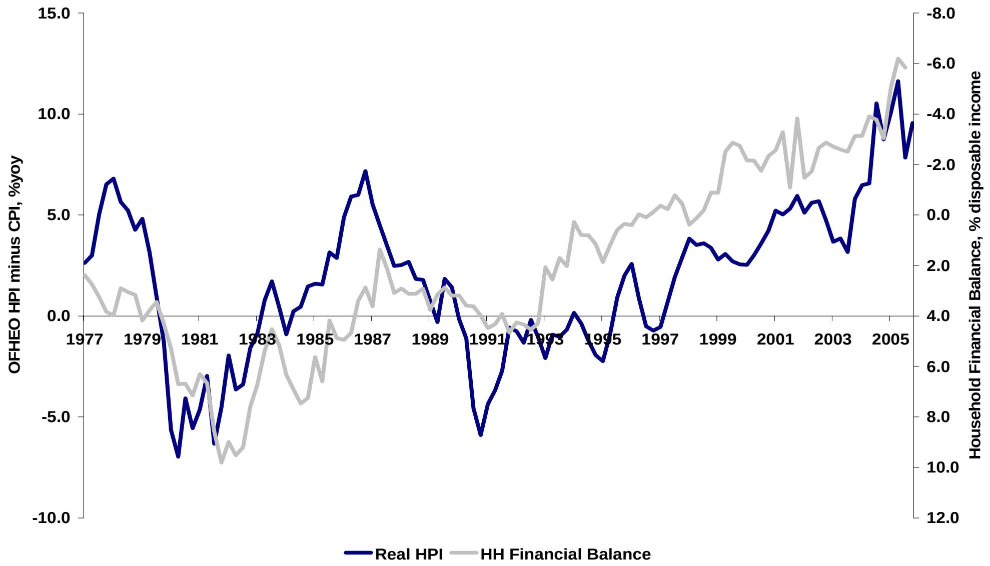
+ The consumer is very sensitive to the price of oil. Real consumption fell 5.4% annualised from August-October 2005, during the Katrina related oil and gasoline price spike. Real consumption rose 10.2% annualised from November to January. If a combination of higher US rates and a moderation of Chinese growth puts downward pressure on commodities this should support real disposable consumer income.

+ Consumer wealth (and wealth net of debt) has risen to an alltime high. This provides a tailwind for consumer sentiment.

But we do believe that the slowdown in the US housing market will have a noticeable effect on US spending. In particular, we expect to see a slowdown in mortgage equity withdrawal lead consumers to slow their debt accumulation, and begin to consume out of income. We also expect to see a slowdown in private investment – which means home improvement and the purchase of newly built houses. The slowing housing turnover will also likely slow consumer durable and furniture purchases, and moderate the demand for freight transport and building materials. We estimate that the decline in the household balance (that's net savings less private investment – spending on housing and on new build houses) that accompanied the rise in house prices from 1997 added seven percentage points to GDP over the 1997-2005 period.

A moderation in house price rises would not see a full reversal of this move. Our suspicion is that it is not just house prices – but also an increased availability of borrowable funds that caused the shift to household deficit.

Chart 9: US real house prices vs the US household balance (inverted).



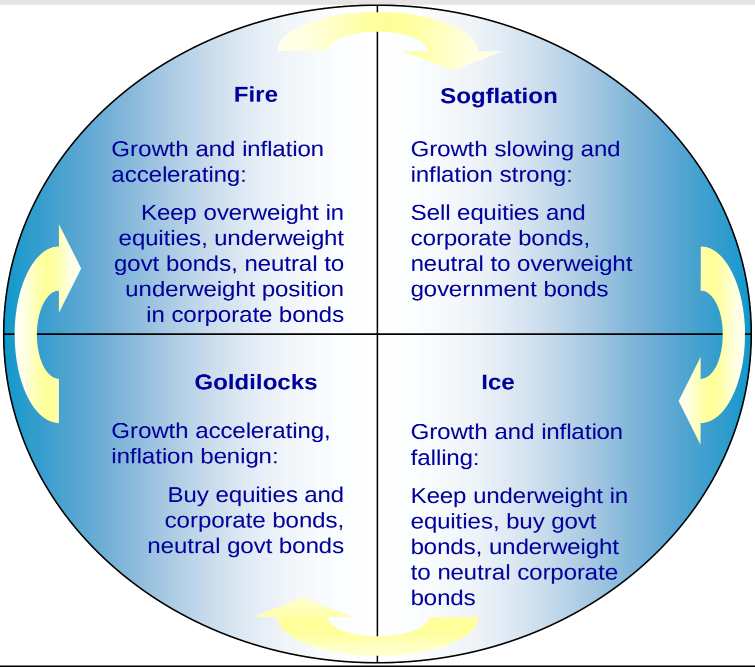
Source: Thomson Financial, LGIM Research

Consequently, the larger risks for US growth show up going into 2007, when any slackening of corporate demand for labour may leave the consumer exposed.

1.6.2 Conclusions

But how does all this translate into active asset allocation? Chart 10 shows an illustration of an Asset Allocation Clock. The diagram aims to show how our views of the global economy integrate with our investment strategy by breaking the global growth/inflation cycle down into four distinct quadrants.

Chart 10: Asset Allocation Clock



Source: LGIM Research

Looking at each quadrant separately, starting with 'Goldilocks', in this environment conditions are not too hot and not too cold. Global growth is accelerating while inflation remains generally benign. These conditions are positive for equities, particularly cyclical stocks, and other higher risk assets, but neutral for government bonds. This describes the investment landscape from March 2003 to around mid-2005.

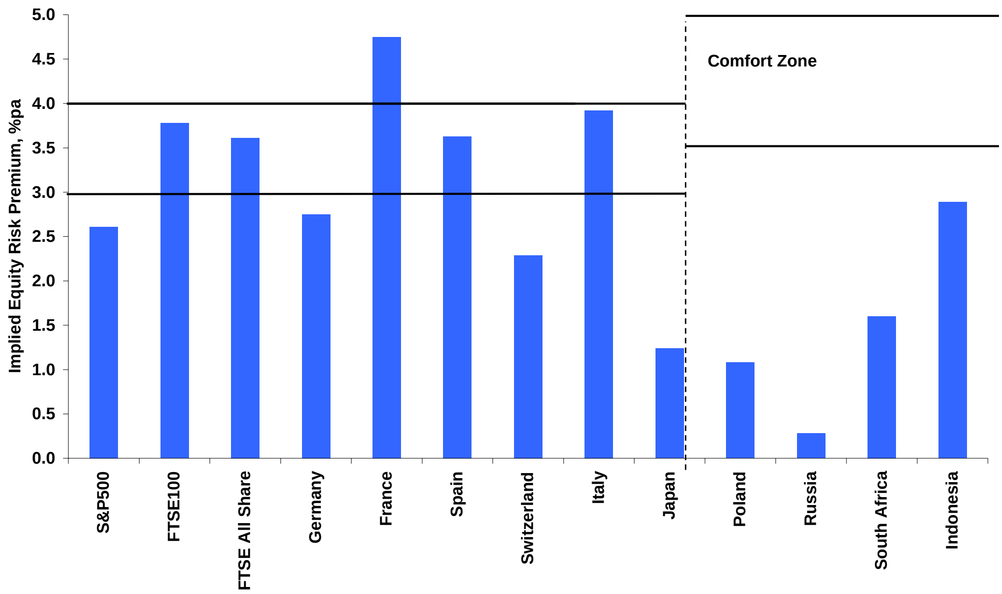
Moving around the clock to 'Fire', in this environment both growth and inflation are accelerating. This is still positive for equities, but is clearly bad for government bonds. It is also characterised by rising commodity prices and hence describes the investment landscape from around October/November of 2005.

The interesting question is what happens next. According to the Asset Allocation Clock, one possibility is 'Sogflation', which is a somewhat milder version of the 1970s style 'Stagflation' with moderating growth but inflation still rising. In this environment equities, corporate bonds and other risky asset classes underperform, while the outlook for government bonds will depend on how strong the rise in inflation is relative to the pace of growth.

However, it is not definite that the whole world will move into this phase together. A more intriguing possibility is that as the Federal Reserve push rates higher, supporting the dollar while lowering commodity prices, the result will be an improvement in the US terms of trade, as in March 1997. This suggests the US could move back into 'Goldilocks', while Asia would be inclined to move into 'Sogflation'.

In summary, we would favour 'boring' developed world equities; those where cash holdings are high and free cash flow yields are in excess on the risk free rate. We believe the risks are tilted against emerging market equities where risk premia have all but vanished. Compressed term premium in mid- and long-dated government bonds, particularly the UK, may widen in this environment.

Chart 11: Equity risk premia in selected markets



Source: LGIM Research